

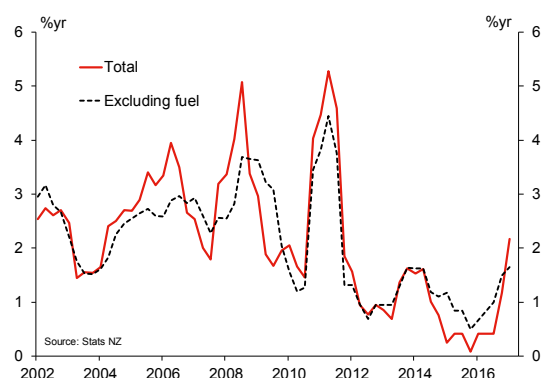
# Inflation pulse strengthening

## March quarter CPI rose 1.0%, annual inflation 2.2%

20 April 2017

- The Consumer Price Index (CPI) rose 1.0% in the March quarter, lifting the annual inflation rate above 2% for the first time since 2011.
- Food and fuel prices made a substantial contribution, though we expect that their impact on annual inflation will wane over the rest of this year.
- Beyond these volatile factors, the underlying pace of inflation has been consistently picking up for the last year.
- The Reserve Bank will be encouraged by the fact that loose monetary policy has successfully lifted inflation back to its target. Nevertheless, we think they will proceed cautiously on the timing and pace of interest rate hikes.

CPI inflation



Consumer prices rose by 1% in the March quarter, lifting the annual inflation rate to 2.2%. This is the first time that inflation has been above the Reserve Bank's 2% target midpoint since September 2011, and marks a rapid turnaround from the near-zero levels that prevailed through much of the 2015-16 period.

The result was slightly ahead of what we and the market were expecting, but was markedly stronger than the 0.3% quarterly rise that the RBNZ had forecast in February. Most of the surprise for the RBNZ was in the tradables components – most likely due to movements in food and fuel prices since February, which we expect will have a short-lived impact on inflation.

Nevertheless, today's result can't simply be waved away. Measures of core inflation, which strip out volatile items such as fuel and food, have been picking up for the last year or so. And with headline inflation back at 2% more than two years earlier than the RBNZ expected, any concerns that wage and price expectations could settle at too-low levels are surely now a thing of the past.

In our view, the uptick in inflation is a strong validation that monetary policy works, with its usual lag of around 1-2 years before it affects inflation. Let's not forget that there was no shortage of doubters on that front this time a year ago, when inflation was lingering near zero. The RBNZ began to lower the OCR in June 2015, and longer-term interest rates, in their usual pre-emptive manner, were falling by late 2014. So the rise in underlying inflation over the last year has been right on schedule.

Of course, the argument runs in both directions: interest rate hikes could be quite effective in bringing the pace of inflation down again. There are signs that the modest lift in longer-term interest rates since late 2016 has already done a lot to cool the housing market, which is an important channel for influencing domestic demand and inflation pressures. So the RBNZ will need to act cautiously on the timing and pace of OCR hikes.

Nevertheless, it now seems unlikely that the RBNZ will hold off on hikes until late 2019, as it had projected in the February *Monetary Policy Statement*. We've pencilled in the first OCR hike for early 2019, which is on the later side of the range of market forecasts. But that timing will be under review in coming weeks, as part of a broader review of our forecasts.

## Details

The 1% quarterly rise in the CPI was strongly influenced by fuel and food prices, which together accounted for a 0.6% increase. The 4% rise in fuel prices reflected the rebound in world oil prices from unsustainably low levels. Indeed, this time a year ago was the low point for oil prices, so we are now past the peak impact on annual inflation.

Food prices typically rise in the March quarter, but the 2.2% rise this year was unusually large. Some of this was due to temporary spikes in fruit and vegetable prices, as poor weather affected harvesting. Another contributor was dairy products, as retail prices were marked higher to reflect the sharp improvement in farmgate milk prices in recent months. We don't expect either of these to have ongoing effects on inflation: this year's poor weather won't affect produce prices next year, and we expect next season's farmgate milk price to be similar to this season.

Outside of fuel and food, tradables prices were fairly subdued, reflecting the strengthening of the New Zealand dollar over the last year. That said, there were a number of import-heavy areas – clothing, used cars, electronic goods – where prices didn't fall as much as we expected. This could be a sign that retailers are starting to reclaim a bit of pricing power, using a fall in import prices to rebuild their margins. Recent business surveys certainly show that retailers have become more optimistic about their ability to raise prices. If that's the case, it could mean a bit more persistence in the inflation outlook than we previously thought.

In terms of non-tradables, the major price increases were largely as expected. Tobacco prices rose 9%, reflecting the annual hike in excise duty, and university fees rose 2% as the new academic year started. Rents and new house prices continued their steady rise, though it's notable that growth in rents (which makes up almost 10% of the CPI) has not shown any real pickup for the last several years.

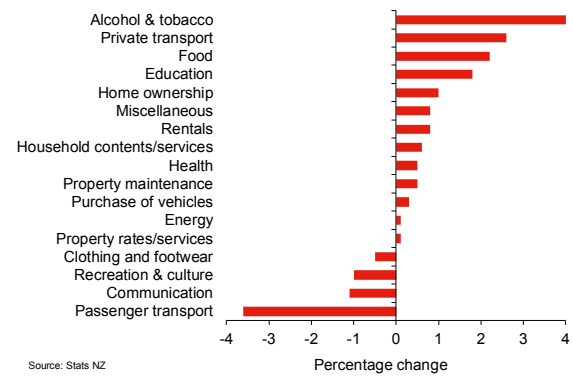
In contrast, new home prices continued to accelerate, even more so outside of Auckland. This series closely follows existing home prices, with about a year's lag – which strongly hints that construction cost inflation is of the demand-pull variety, rather than cost-push. With house prices effectively flattening out over the last six months, it's not clear that the homebuilding industry will be able to justify rampant price increases for much longer.

Another notable factor on the domestic front was airfares, which rose sharply for a third straight quarter. In seasonally adjusted terms, domestic airfares are almost back to their 2015 highs, despite a steep fall in fuel costs since then. In contrast, international airfares, where there is much more competition, have remained low in that same time.

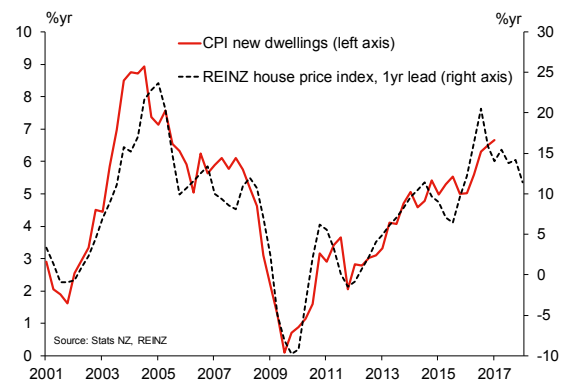
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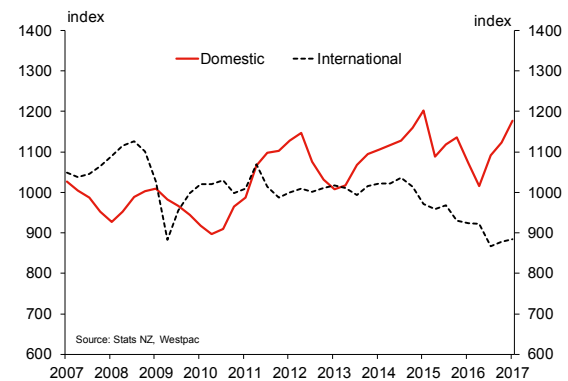
## Components of quarterly inflation



## House price inflation



## Airfares, seasonally adjusted



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